2020 Life Insurance Company Success Story

by Max J. Rudolph

Conditions faced over the next 10 years will determine the characteristics of successful U.S.-based life insurance companies in 2020. Continued low interest rates will disadvantage in-force blocks since interest earned will be less than expected. Material interest rate rises would cause those same insurers to suffer. New entrants will challenge previously dominant firms for new sales. What follows is a potential outcome of a reasonable scenario based on conditions looking forward from September 2009.

Economic Scenario 2009–2020

Following the financial crisis that began with the Federal Reserve induced stock market bubble in 1995 through the 2009–2012 influenza pandemic and Iran/Russia/Venezuela driven oil disruption in 2015, this period was a roller coaster ride for the life insurance industry rivaling the previously uncharted period of 1965–1985. The pandemic hit the economy hard, as did several terrorist events.

In hindsight, these two periods proved to be very similar. Markets were volatile, even on their way up, and then broke. In the 1960s guns and butter spending (funding simultaneously for the Vietnam War and new social programs like Medicare) created pent-up inflationary pressures that were only released when expectations for inflation increased with the dual oil price shocks of 1973 and 1979.

The period starting in 1995 had already seen reduced interest rates drive increases in value of financial assets. The Dow Jones Industrial Average, a bellwether of stock values, increased from 1,000 in 1982 to a high of over 14,000 points in 2007. The dot-com bubble burst shortly after the millennium, followed by the horrific events of Sept. 11, 2001. Interest rates were reduced to stabilize markets. Those lower rates encouraged home ownership through a variety of new tools. When cracks in the financial markets led to widespread liquidity freezes, the U.S. government tried solutions including bailouts of those "too big to fail" and low interest rates. The pandemic lengthened the crisis. Over time the Treasury curve steepened dramatically. By 2015 rates began to rise, and central banks around the world were forced to intervene with higher rates to slow inflation when oil supplies were cut.

The pandemic caused life insurance product redesigns, reducing initial death benefits. High mortality claims and increased counterparty risk resulted in an accelerated consolidation of the industry, which is considered an oligopoly today. Companies selling participating life policies, mainly those operating under a mutual charter, performed better than those writing term policies. Several reinsurers went belly-up when the U.S. death rate suffered through 0.3 percent (1 million deaths) excess mortality over 2010–2012.

Regulation

This scenario led to national insurance legislation in 2015, adding national health care and moving the life/health insurance industry to a federal charter, regulated along with other financial services firms like banks. By 2020 the federal government had five years to build up their insurance regulatory staff. At first they worked quite closely with the NAIC, but over time their focus has moved to consistency with financial service regulatory regimes overseas. The state insurance departments became outsourcing vendors competing with others for audit, compliance and actuarial functions.

Marketplace

Surviving firms have focused on specific risks rather than trying to be all things to all people, forming alliances with other focused insurers.

With numerous stresses in the financial world since 1995, insurance products became simpler and more transparent. Insurance agents retired at a faster rate than they were replaced, and consolidation eliminated many companies from the brokerage market. As a result, the fee-for-service model expanded, with a financial services planner shopping online for the appropriate product.

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Family offices became more prevalent, with actuaries providing "Personal ERM" services.

Company consolidation sped up after the federal charter was put in place and regulation expanded. An oligopoly formed by the survivors kept prices high but consistent throughout the industry. This allowed a new entrant, Wal-Mart, to take market share at the smaller size and rural part of the market much as they had done for banking. Their focus on enterprise risk management and pricing discipline has made Wal-Mart a key player in these markets.

Life Insurance Products

After the pandemic there was a shift toward products with reduced initial death benefits that generated reserves and cash values. This reduced company risk and lowered capital requirements. A group whole life product was reintroduced to the marketplace with features allowing portability. The price of term life policies went up markedly after the first primary reinsurer went under and was not saved.

One of the first securitized products to come back after the financial issues of 2008–2010 involved life settlements. With mortality independent of financial variables, private equity investors were willing buyers. This had a material impact for life insurers, as many existing policies were lapse-supported, with assumptions that some policies would lapse with value remaining in the contract. Someone with little probability of dying soon would take the cash value at lapse while someone with increased likelihood of collecting on the policy now had an outlet to get the money. As it turned out, these securitizations were poorly priced. They focused on mathematical modeling rather than actuarial knowledge of the subject. This left policyholders as the winners while investors and insurers struggled. A firm writing primarily term or with an aging block of whole life policies was especially susceptible to this risk. By 2020 pricing assumptions required a sensitivity with no lapses.

Annuity Products

Fixed account products continue to be popular but design features have evolved so there are no interest rate floors. The long period of low interest rates caused many companies to report losses on their large deferred annuity blocks. Once the federal charter was put in place, the required floor was eliminated, and transparency in the marketplace determined guarantees. Today more liabilities are tied directly to assets purchased to back them, with the investment risk passed through and no guarantee wrappers attached.

Payout annuities have become more prevalent since the 10-year stagnant stock market forced future retirees to save more if they hoped to meet their goals. A recent development has allowed an individual to pay into a participating payout annuity, with benefits based on additions using current attained age. The buyer purchases some units of future payout using their age today. Later they can buy more, based on their attained age. Assumptions are conservative. Dividends pass along investment gains, expense savings and excess mortality beyond what was priced for and allocates additional units of payout benefit to the future annuitant. The product is fully portable and has been very popular in the 401(k) market.

Variable Products

Products backed by mutual funds have struggled to succeed in the low return market of recent years. Most variable life products have lapsed without value as the funds dried up. Variable annuities struggled after the derivatives market seized up, and hedging programs were found to be both less successful and more expensive than promised. Pure vanilla variable annuities, sometimes with nothing beyond a death benefit rider, are being offered again.

Group Products

Companies focused on group term insurance were impacted badly by the pandemic as they had large blocks of busi-

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ness in the affected age groups and few assets to back them. Several large writers did not survive, and public perceptions of group term worsened. The group market adjusted to offer a cash value product that was portable.

International Developments

The financial crisis, pandemic and oil shock hit hard in all countries, but the rebound came more quickly in developing markets. While Europe followed the United States and experienced slow growth and weakening currency, growth in BRIC (Brazil, Russia, India and China) came back more quickly until Russia had its internal civil war starting in 2017. Rather than develop its own insurer, Brazilian investors took advantage of the falling value of the dollar to purchase an existing insurer in North America. Similarly, investors in India bought a European insurance giant, and China became the home office location for AIG. These transactions were made much easier when the federal charter imposed national regulation on insurer solvency. Showing its agility, Wal-Mart's insurance division recently expanded into Canada, Mexico and China.

Summary

The economic path taken will determine the traits of successful firms. If the scenario described plays out, new entrants and foreign firms will have an advantage. In-force blocks will act as a drag on existing life insurers as life settlements and low interest rates drive more efficient policyholder behavior. Industry consolidation will accelerate, favoring large insurers who focus on mortality risk with whole life products, pass through equity risk and keep expenses low. Products will evolve to add more portability and payout annuity options. A fee-for-service planner model will continue to replace commission-based agents. Regulation will increase under a federal charter, and international consolidation will accelerate among financial services industries. A cheap dollar will put U.S.-based insurers at a disadvantage.

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